U.S. House of Representatives Committee on Small Business Hearing
October 14, 2009
"Increasing Access to Capital for Small Businesses"

Testimony of:
Suzette Dutch, Managing Partner
Triathlon Medical Venture Partners
Cincinnati, OH
On Behalf of the National Venture Capital Association

Introduction

Chairwoman Velazquez, Ranking Member Graves, and members of the Committee, my name is Suzette Dutch and I am a co-founder and managing partner with Triathlon Medical Venture Partners, a venture capital firm headquartered in Cincinnati, Ohio, with offices in Indianapolis, Louisville, Ann Arbor, and St. Louis. Triathlon is an SBIC that was licensed in 2004 with $60 million in SBA participating securities and $45 million in private institutional capital. We provide equity capital and business expertise to early and expansion stage companies with proprietary biomedical technology platforms or products addressing significant human healthcare needs. Our $105 million dollar fund has already repaid over $12 million of SBA's participating securities from 2 profitable exits. Our financial results place our performance in the top half of all venture funds of the same age using standard industry benchmarks.

By virtue of our regional presence and capital funding, Triathlon is one of the leading sources of early-stage life science investment capital in the Midwest. We make investments in early-stage opportunities, typically when there are only a few employees and a great idea. We will invest from $0.25 million to $5 million in the initial round and up to $8 million total per company in subsequent rounds as the company grows, reaches agreed upon milestones and requires additional capital. Triathlon has led 14 of its 17 investments. Syndication, which takes place when multiple venture firms come together to meet larger funding needs, is important to us and a necessity to provide our portfolio companies the capital, expertise, and networks they need to reach the finish line – returns to our investors in the form of an IPO or acquisition.

Our portfolio of 17 companies in life sciences includes 2 which were sold to market leaders in their respective fields. One of these companies, Renal Solutions, is a Pittsburgh headquartered company with technology that enables dialysis patients to be cost effectively and better treated in their homes. It was sold in 2007 to Fresenius the world leader in dialysis. Importantly the company headquarters remains in Pittsburgh operating as a separate subsidiary and cartridge manufacturing continues in Oklahoma as the acquirer recognized that innovation takes place in small companies. The majority of our 15 remaining companies are in the undercapitalized Midwest with 3 in Indiana, 2 in Ohio, and one each in Michigan, Missouri, Minnesota, Tennessee, and Kentucky. Endocyte, for example has clinical trials in ovarian and lung cancer underway and even before reaching the market employs 60 people in Indiana.

In addition to my responsibilities as a venture investor, I am also a member of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of more than 400 venture capital firms like ours in the United States which comprise more than 90 percent of the venture industry's capital under management.

It is my privilege to be here today on behalf of the venture capital industry to support the Small Business Early Stage Investment Act of 2009. We believe that this bill puts forth a tremendous opportunity to fund *more* of the most promising small businesses our country has to offer. The venture capital industry has consistently supported the notion that significant value can be created when the government and the private sector work together to bring new ideas and innovation to life. The intent of the Small Business Early Stage Investment (SBESI) program appears to do just that and promises to be particularly beneficial to regions of the country that today are underserved in terms of access to capital.

The Importance of Early Stage Investment

In 1962, a small early stage company based in Minneapolis with an idea for a battery-like device that would regulate a patient's heartbeat received $100,000 in venture capital investment. Eleven years later, in 1973, an entrepreneur had a concept that would allow packages to be sent across the country overnight. He received $10 million in seed money to bring that company to market. And, in 1987 a computer savvy young man obtained $17 million to start a hardware company in Austin, Texas. These small start-up businesses grew into Medtronic, FedEx and Dell Computer and are representative of thousands of companies that transformed their industries and their regions because they were funded and supported early on in their life cycle.

A commitment to investment in early stage companies has been a key differentiating factor in our country's ongoing economic leadership. The venture capital industry invests billions of dollars each year into innovative ideas that have the potential to grow into world class companies. Often these ideas are not even businesses yet, but reside in the minds of entrepreneurs, scientists or engineers. These individuals typically have the intellectual capacity and vision to do great things but lack the risk capital and business expertise to bring their concepts to life. At one time or another, every blue chip company in the United States was just an idea. In addition to the three examples above, companies such as Genentech, eBay, Google, Amgen, Intel and Starbucks were also once early stage start ups. In 2008, companies that were originally funded by venture capital accounted for 12.1 million employees and represented 21 percent of US GDP. And, according to StartUp Hire, there are currently more than 10,000 job openings at early stage start-ups across the United States. Investment in these companies is a proven job creator.

The venture industry supports the SBESI program on behalf of the next Amgen, Google or Starbucks. There have traditionally been limited funding sources for these ventures which carry significant entrepreneurial and technological risk. In the current economic climate even traditional institutional investors have slowed their commitments to the asset class making the need for public collaboration more critical to these engines of future economic prosperity. Given the probability of failure and the lack of collateral in their early years, these start-up companies are not able to qualify for traditional commercial loans. The long term nature of the investment required and the expertise to select and nurture these ideas typically keeps other alternative providers such as buyout shops and hedge funds away. Thus these entrepreneurs rely on bootstrapping, friends and family, angel investors, and venture capital firms for early stage funding. Some seek government grants which are incremental to private sector sources but not enough to go the distance to being financially viable, especially in sectors that require large amounts of capital such as life sciences and clean energy. The SBESI program would bolster the country's ability to offer promising companies a better chance to grow and thrive at a time when we need more jobs and stronger economic growth.

The choice to implement the SBESI program through established venture capital firms is a good one. It recognizes that intelligent investing and measured risk taking requires more than just capital. More money alone will not guarantee a favorable outcome. That money must come with expertise and guidance from professionals who understand the industries, competition and strategic landscape in which the start-ups are operating and who have the networks of relationships to assist these companies as they grow. Additionally the program must align interests of the companies' founders and management with the capital providers. Venture capital firms well understand how to structure investments to achieve this win-win outcome. Together, additional capital and this expertise are critical ingredients and will serve areas of the country such as mine very well.

Support for Promising Regions

While venture capital investment is a national industry and there are venture backed companies in every state, there is undoubtedly a concentration of funds in particular regions. Silicon Valley is the dominant region for both venture capital firms and the companies in which our industry invests. Other well funded areas include Boston, New York, Austin and San Diego. Here there are long established venture capital funds with support from the institutional investor community making billions of dollars in investment each year. Other areas such as the Pacific Northwest, the Southwest and Mid Atlantic region have shown promising growth in the last several years. Still there remain other parts of the country where the SBESI program would do tremendous good.

For example in Ohio, where my firm is headquartered, venture capitalists invested $39 million in 17 companies in the first half of 2009 compared to the $3.4 billion which was invested in 476 California companies during the same time period. Ohio – as well as other states in our geographic footprint such as Missouri, Indiana, Michigan and Kentucky– is not lacking energized entrepreneurs, robust university labs, leading medical institutions or other factors that drive venture investment. We, for the most part, are lacking dollars to invest. The opportunity to apply for and receive SBESI funds to invest in local companies would be welcome by my firm and others like mine that have access to more great ideas than we can fund on our own.

Key Factors for Success

The Bill as it is currently proposed is an excellent start to offering the right incentives to the right stakeholders. By requiring privately managed investment companies to have capital commitments from non-federal sources that are at least equal to the amount of the grant request, the Bill puts in place an inherent vetting system and offers the SBA a level of comfort that the fund applicant already has the support of accredited investors. Limiting the grant to $100 million for any single investment fund will support investment in multiple funds providing appropriate diversification for the government and participation by a larger number of funds to allow for syndication. The focus on early stage investment opportunities channels government funding where it has historically been the most successful, in the nascent years of a start-up company as well as where the gap is greatest – between academic grant funding and expansion funding.

We also applaud the diversity of industry sectors to which the SBESI program would apply. By including information technology, life sciences and clean technology, the bill guarantees that the program will be in a position to impact the most promising and fastest growing industries in the country. Not only do these industries create high value jobs and revenues, but they are also poised to bring the next wave of innovation in medical care, climate sustainability and information delivery to Americans, keeping our country competitive and improving our quality of life.

As we move through the legislative process, there are details that we believe deserve further consideration in order to maximize the success of the program. For instance, the bill currently states that the SBESI fund would be required to be drawn down within five years. Although most venture capital funds draw down capital for new investments within the first five years, most venture capital funds have a ten year life, plus two or three one-year extensions if necessary for an orderly liquidation. This permits those funds to draw down capital for follow-on rounds of investment in existing companies after the initial 5-year investment period, allowing them to support their portfolio companies throughout their life cycle, and to draw down capital to pay expenses as they come due. Without this flexibility, venture capital funds would be prohibited from making follow-on investments or from paying expenses during the life of the fund. Additionally, non-federal investors would have opportunities for follow-on investment that the SBA would not, which is not contemplated under the language of the legislation. We would recommend that the language be amended to permit draw downs of capital to be made for investment in new companies only during the fund's first five years, but to also allow draw downs of capital to be made for follow on investments or for payment of expenses in the later years of the fund. This language would be more consistent with industry norms and could be tempered with a maximum percentage that could be drawn after the first five years.

Another area of potential concern is the requirement that distributions be made to all investors only in the form of cash, without the option for distribution in the form of freely tradable public stock. In the private sector, most fund agreements allow a firm to distribute freely tradeable public stock in the wake of an IPO, recognizing than an IPO is often another form of financing a company's growth and not a liquidity event. By requiring that ALL investors, even non-federal investors, receive only cash distributions, the bill prevents those investors from sharing in the potential upside from post-IPO stock appreciation. This requirement may dissuade outside investors from committing to the fund. An alternative would be for distributions of freely tradeable public stock to be permissible. In this case, the SBA could immediately sell any stock distributed to it and receive cash, but outside investors could act in their own interest and, if they prefer, hold the stock prior to selling.

Lastly, the bill states that "funds from the SBESI program will only be given to highly qualified investment funds with experienced managers that have a proven track record of returning a profit to its investors." While this language is at face value extremely reasonable, it could become problematic for managers whose funds have not yet matured or were part of a troubling vintage year. Profitability of a venture fund is often not realized for 10-15 years. As an example, funds being evaluated during the current economic crisis may ultimately be profitable but today have yet to realize any return. Thus, the current snapshot may not reflect the manager's true ability. We suggest the language be amended to reflect a manager's performance as it relates to an established industry benchmark as opposed to pure profitability.

Conclusion

On behalf of the venture capital industry, we appreciate the efforts by this committee to support entrepreneurs by offering additional funding through the SBESI program. We support this legislation as it takes into account the realities of start up investing and allows the government to participate as a third party investor in an effective and efficient manner. This bill also fills an important gap left by the closed participating securities program by financing the types of businesses we finance, namely those whose long road to profitability can not support a current interest payment required by the SBA's debenture program. By having SBA and private limited partners get their returns at the same time and at the same level, this program is structured in a way that can eventually become self-sustaining.

The SBESI program is poised to support regions of the country that today are underserved and have less access to risk capital than areas heavily populated with venture capital firms and venture-backed companies. The opportunity is significant. One only has to see what companies such as Dell and Medtronic did for Austin and Minneapolis to understand how important it is to nurture these start-ups in their earliest phases. I remain bullish on the prospects for the region surrounding Ohio, Missouri, Michigan, Kentucky, and Indiana to grow more companies from the ground up under this program and we at Triathlon have demonstrated that belief by locating our fully staffed offices in those states.

We look forward to working with Congress and the SBA to address the nuances we described which will maximize the appeal of the program to venture capital firms and their limited partners. I am happy to answer any questions.